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THE DODD FRANK ACT: ITS EFFECT ON MARKET PARTICIPANTS IN AUSTRALIA

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A. Introduction

Since the audience today consists largely of lawyers, you will be pleased to know that the Dodd Frank Wall Street Reform and Consumer Protection Act (the "DFA") is a boon for the legal profession. The DFA itself is over 800 pages long and, according to The Economist newspaper, as at 7 May 2011, the regulations that accompany the DFA were already 3 million words long, highly complex and not yet half written! While there is still uncertainty as to the extra-territorial scope of this law, any Australian financial services provider who deals with US clients or deals in derivatives in the US will be potentially affected by it.

In an effort to produce something that might be of some use to you, I have focused my paper on derivatives. It would be unmanageable in the context of this paper to attempt to discuss the DFA as a whole. The DFA makes sweeping changes to the US financial services regulatory framework. It includes new registration requirements for investment advisers, fund managers and private equity funds. It introduces credit-rating agency reform, living wills for banks, new rules on capital and systemic risk, and on investor and consumer protection. However, the DFA provides little detail on many definitions and important provisions, leaving the regulations to flesh out how the principles established by the DFA are to be translated into practical requirements.

B. Overview of the Dodd Frank Act as it relates to Derivatives

The DFA introduces four major changes to the regulation of OTC derivatives:

(1) the regulation of OTC derivatives and the entities involved in the OTC derivatives business;

(2) the regulation of central clearing houses which are to clear most OTC derivatives contracts;

(3) the regulation and new role of trading venues ("swap execution facilities" or "SEFs"), on which many OTC derivatives will be traded; and

(4) the regulation and new role of trade repositories in reporting OTC derivatives data to bring transparency to the OTC derivatives markets.

The Commodities Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") are charged with responsibility for promulgating the regulations relating to derivatives. The CFTC will regulate "swaps" (examples of which include interest rate swaps, equity index swaps, credit default swaps, commodities derivatives, various foreign exchange derivatives) and the SEC will regulate "security based swaps" (such as total return swaps on a narrow based security index and on a single security or loan, and credit default swaps on a single entity or a narrow based basket of entities).[1] While some provisions of the DFA will become effective as early as 16 July 2011, the Commissions recently issued orders effectively delaying compliance dates for provisions that rely on the definition of terms and rulemaking that are still to be completed. The new effective dates will generally be 60 days following adoption of final rules.

1. Registration of swaps dealers and major swap participants

"Swap dealers" and "major swap participants" will be required to register with the CFTC and SEC, respectively (or both, if an entity deals in both swaps and security based swaps). Dealers and major swap participants are subject to transaction requirements (e.g. business conduct rules and record-keeping and trading documentation requirements) and entity requirements (e.g. capital, margin reporting, position limits and risk management requirements).

The DFA generally defines a "dealer" as a person who holds itself out as a dealer in swaps, or makes a market in swaps, or regularly enters into swaps with counterparties in the ordinary course of business for its own account, or engages in any activity causing the person to be known in the trade as a dealer or market maker. Essentially, being a "dealer" involves acting as a principal in entering into a relevant trade.

The DFA has also created a special category called "major swap participant" ("MSP") to regulate entities with significant positions in the derivatives markets. The regulations contain specific criteria to determine whether an entity is a MSP. Entities that trade derivatives solely to hedge or mitigate commercial risk are unlikely to be MSPs. The policy rationale for the creation of the MSP category is to ensure regulatory oversight of entities which are systemically important or which could impact the US financial system.

The DFA provides the Commissions with broad authority to further define both a "swap dealer" and a "MSP".

[1] The SEC has historically had jurisdiction over OTC derivatives on single name and narrow based indices of equity securities (e.g. put and call options, forwards, and instruments involving combinations of them). These instruments, which are already treated and regulated as securities, are not subject to the DFA.

2. Swap central clearing

The DFA requires "financial entities" to have their swaps cleared by a central clearing counterparty regulated by CFTC (for swaps) or SEC (for security-based swaps). Financial entities subject to the central clearing requirement include swaps dealers, MSPs, employee benefit plans and persons predominantly engaged in banking business or activities that are financial in nature. Cleared swaps will be subject to margin requirements defined by the Commissions.

Swaps subject to mandatory clearing may still be exempt from clearing if at least one counterparty to the swap is not a "financial entity", is using swaps to hedge or mitigate commercial risk and notifies the CFTC or SEC (as the case may be) as to how it meets its obligations in connection with non-cleared swaps. There is also an exemption from the mandatory clearing requirement if no clearing organisation is willing to clear the swap.

Uncleared swaps will be subject to higher margin and/or capital requirements than cleared swaps.

3. Swap execution

All swaps required to be cleared are also required to be executed on a regulated exchange or SEF.

At this stage many OTC derivatives are not able to be traded on exchanges or SEFs. There is still some uncertainty as to whether dealer models will qualify as SEFs. For less liquid, non-commoditised swaps, there is a concern that mandating the trading of these swaps on exchanges or SEFs will adversely affect pricing and liquidity. As with Australia, global OTC derivatives activity is dominated by interest rate derivatives (see chart below).

Global Derivatives Market by Product		
Interest rate	$364 trillion	78%
FX contracts	$63 trillion	14%
Credit products	$27 trillion	6%
Equity-linked	$7 trillion	2%
Commodities	$3 trillion	1%
Total	**$464 trillion**	Percentages do not total 100 due to rounding.
		Source: Deutsche Bank

As ISDA has noted (see chart below), there are substantial differences between derivatives which are currently traded over-the-counter and derivatives which are currently traded on exchanges.

Characteristic	**OTC Swaps**	**Listed Futures**
Trading Counterparties	<1,000	>>100,000
Retail Participation	None	Significant
Daily Trades	<20,000	>1,000,000
Tradable Instruments	>>100,000	<1,000
Trade Size	Very large	Small

Depending on how far the Commissions go in forcing OTC trades onto exchanges, this could lead to these derivatives taking on the characteristics of existing listed futures, with consequences such as substantial increases in the volume of trades, a decrease in the types of tradable instruments and a decrease in the trade size.

For end-users of derivatives, standardisation of derivatives contracts and a decrease in trade size is likely to make hedging more difficult to execute (for example, trading banks seeking to hedge their interest rate risks through interest rate swaps may have to enter into more trades and more frequently to execute their hedge). Standardisation of derivatives contracts will also often introduce basis risk for the user (i.e. the risk associated with imperfect hedging) leading to greater costs for end-users.

In addition, these effects and the increased transparency of exchange traded products will result in margin compression for banks and financial intermediaries. In the face of these pressures, banks and financial institutions will, in our view, have to radically alter their cost base to maintain anywhere near their current levels of profitability. A critical element in achieving this outcome will be the speed, efficiency, scalability and reliability of information technology systems. However, even with an aggressive reduction in their cost base, banks and financial institutions in these markets are likely to experience lower profitability as a result of the DFA's reforms to OTC derivative markets.

4. Swap reporting

The DFA requires each party that enters into a swap to report details of such swap trade *"as soon as technologically practicable"* to a swap data repository that is registered with the CFTC or the SEC (as applicable) or, if there is no swap data repository that will accept such a swap, to the CFTC or the SEC, as applicable. The reporting requirement applies to all swaps, not just to those which are centrally cleared. Where one party to the swap is a swap dealer or MSP, the reporting obligation rests with the dealer or MSP. The reporting requirements apply to existing swaps, as well as to new swaps entered into after the reporting requirements take effect.

The data repositories are required to aggregate the data received on trading volumes and swap positions and to publish that data (but not the identity of the parties). The swap data repositories are also required to provide details of information held in relation to swap trades to US regulators.

The aggregation and publication of aggregated data is occurring already in relation to some OTC derivative products. Deutsche Bank is submitting trade repository reports on the derivative open positions of its branches across many asset classes to DTCC and TriOptima (soon to be replaced by DTCC) on either a weekly or monthly basis, depending on asset class. Front office feedback is that the process is relatively painless, although the data that is published is not particularly meaningful.

C. Comparison with other jurisdictions

The G20 Leaders in September 2009 made a commitment (the "Pittsburgh Commitments") that, "*all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared though central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements*."

Global derivatives reforms since the Global Financial Crisis have been driven by the Pittsburgh Commitments. However, a comparison of the reforms taking shape in the US and Europe illustrates that divergences in approach and differences in timetables are emerging (see chart below). In April 2011 the Financial Stability Board expressed concern that many G20 countries may not meet the end of 2012 deadline.

1. Europe

In Europe, the European Markets Infrastructure Regulation ("EMIR") is being developed to regulate OTC derivatives, central clearing counterparties and trade repositories and will apply to over-the-counter derivatives transactions. The new rules are in the form of an EU Regulation, rather than an EU Directive, because Regulations apply directly to EU member countries without the need for implementing legislation. The European Securities and Markets Authority ("ESMA"), the new European securities and markets supervisor, will be responsible for identifying contracts subject to clearing and will oversee trade repositories, supporting national authorities with central clearing counterparty ("CCP") supervision and will draft technical standards for EMIR. National supervisory authorities will be responsible for CCP authorisation and supervision.

Financial institutions will be required to have centrally cleared all "eligible" OTC trades. Non-financial counterparties will be subject to the central clearing requirement if the OTC derivatives position exceeds the "clearing threshold" as specified by the European Commission. Unlike in the US, pension funds will not be required to centrally clear their OTC trades until at least 2015 (although because of the margin requirements on trades conducted by financial institutions, pension funds will need to post collateral, which will create a drag on their returns).

Similar to the DFA requirements, non-cleared trades in the European Union will carry additional capital charges for financial institutions or be subject to margining requirements.

All derivatives transactions will be required to be reported to a trade repository within one day of execution (as opposed to "as soon as technologically practicable" which I have already mentioned is the US requirement).

Trade repositories will be required to aggregate and publish derivatives trade data. If there is no applicable trade repository, the trade must be reported to the relevant national authority. Trade repositories must be registered and monitored by ESMA and will be subject to requirements regarding operational reliability, safeguarding information and transparency. While European regulators are expected to pursue stronger oversight of derivatives positions, this is likely to be by way of position management rather than by hard position limits (as opposed to the US which is imposing hard limits).

In addition, the European Commission has undertaken a review of MiFID (Markets in Financial Instruments Directive) and in December 2010 published a consultation paper which, inter alia, addressed the trading of OTC derivatives on trading platforms and transparency and position limits in relation to OTC derivatives. The European Commission is expected to propose draft legislation on the MiFID review towards the end of this year, with an implementation date at the end of 2012.

Under the MiFID proposals, which apply to all derivatives, OTC trading will be moved to regulated trading venues as much as possible and derivatives contracts which are eligible to be centrally cleared and are sufficiently liquid may be required to be traded on a regulated market or other regulated trading venue such as a multi-lateral trading facility or an organised trading facility. ESMA will determine which contracts are eligible contracts and sufficiently liquid for this purpose.

The chart below summarises key differences between the European and the US approach.

EU versus US Considerations		
	European Union	**United States of America**
Scope	• EMIR likely will only apply to OTC derivatives • MiFID will apply rules to all derivatives, including exchange-traded derivatives	• DFA covers all types of swaps, both bilateral and cleared
Timing	• Adoption of EMIR expected Q4 2011 • ESMA to write EMIR technical standards by H1 2012, likely with phased-in clearing requirements	• DFA signed into law July 2010 • CFTC/SEC to finalise derivatives rules Q2/Q3 2011, with phasing-in expected
Exemptions	• FX: FX swaps and forwards expected to be exempt from clearing requirements (likely to be determined by ESMA) • Pensions: Bilateral risk mitigation instead of clearing for 3 years (pending review)	• FX: US Treasury has exempt FX swaps and forwards from clearing, exchange trading and margin requirements • Pensions: Will not be eligible for the end-user exemption from clearing requirements
Position Limits	• Regulators expected to pursue position management rather than position limits	• CFTC/SEC final rules on individual instrument and aggregate limits expected US summer 2011
Extra-territoriality	• Consideration of applicability to 3rd country entities will be critical as EMIR and MiFID rules are finalised	• CFTC/SEC have not yet fully addressed the extra-territorial application of their rules; areas of concern include swap dealer rules, deference to home country regulators, 3rd country entities

2. Asia

In Japan, more limited reforms are underway than in the US and the European Union, although these reforms are more comprehensive than most Asian jurisdictions. Key Asian financial centres have not initiated comprehensive reforms analogous to those proposed by the US or the European Union. It appears that Asian jurisdictions will resist pressure to adopt US regulations, although as is clear from the chart below, they are moving to ensure that they are broadly in line with international supervisory standards, particularly in relation to central clearing.

Comparison of Global Derivative Reform Efforts Underway (Includes Plans Through 2012)									
Focus Area	**U.S.**	**Canada**	**Europe**	**Japan**	**Singapore**	**HK**	**South Korea**	**India**	**China**
1. Regulation of Dealers	✓	✓	✓	✓	✓	✓	✓	✓	✓
2. Definition of "Swap"	✓								
3. Regulation of Significant Participants	✓		✓	✓					
4. Central Clearing Requirement	✓		✓	✓	✓(optional)	✓	✓	✓	✓
5. Regulation of Clearing houses	✓		✓	✓		✓	✓	✓	✓
6. Exchange Trading/ SEF's	✓		✓						✓
7. Post-Trade Reporting Requirement	✓		✓	✓		✓	✓	✓	✓

Canada does not yet have "official" Government led reform proposals underway (Canadian Securities Administrators proposal only)

China has a very small, reasonably "closed" and very highly regulated derivatives market; not a good comparable for other major derivative markets

The main changes being implemented in Asia are in relation to central clearing (see the chart below).

Country	Local Clearing House	Date	Update on timing
Japan	Japan Securities Clearing Corporation	• 19 July, 2011 • August 2012 • November 2012	• JSCC expected to begin clearing Credit Default Swaps ("CDS") (potentially postponed) • JSCC expected to begin clearing Interest Rate Swaps • Mandatory central clearing and reporting effective date
Singapore	SGX Derivatives Clearing Limited	• November, 2010 • July/August 2011	• Singapore Stock Exchange becomes operational as CCP • Target date for having non-deliverable FX forwards clearing
Hong Kong	Hong Kong Stock Exchange (announced)	• Q3 2011 • End of 2012	• SFC to consult market on new OTC derivative regulatory regime • Target date for establishment of central clearing & trade reporting facilities and requirements
Korea	Still TBD (2 candidates are Korea Stock Exchange & Korean Securities Depository	• 2H 2012 • Mid-2012	• Possible introduction of derivatives legislation to Korea National Assembly • Target date for establishment of CCP
India	Clearing Corporation of India Limited	• July 2011 • 2012	• Target date for establishment of domestic CDS market • Target date for mandatory central clearing requirement
China	Shanghai Clearing House	• 20 June, 2011 • 2012	• Effective date for January 2011 new derivatives regulations for China bank sector (mixture of new restrictions) • Shanghai Clearing House expected to become operational

Given that London has existing, fully operational large-scale clearing across all major asset classes and the European regulatory regime offers greater flexibility and is less prescriptive than the US regime, we expect that London will be the principal beneficiary of the G2O push towards central clearing. In the longer term, it may be that Singapore and/or Hong Kong will also be beneficiaries. However, because their clearing facilities are not as extensive as those London currently offers, we do not believe this will be the case in the near term.

D. What do the Dodd Frank Act reforms mean for Australia?

1. Extra-territorial effect

The question of extra-territorial application of the DFA remains among the most uncertain and problematic aspects of the reforms for non-US banks that conduct global swap dealing operations. If the DFA and regulations are given broad extra-territorial scope then the global activities of non-US banks, including Australian banks, could potentially be subject to both US and non-US regulation, giving rise to duplicative or potentially inconsistent compliance obligations.

In particular, there are open questions as to:

(a) Whether US regulatory requirements (such as <u>entity level</u> requirements relating to capital and risk management and <u>transaction level</u> requirements relating to clearing, exchange trading, reporting and business conduct rules, for swaps) would apply to swaps entered into by a non-US bank (or a branch thereof) that is registered as a swaps dealer. Foreign banks are advocating for the US <u>transaction requirements</u> to apply only to their swaps with US counterparties and not to swaps with non-US counterparties. (For securities related transactions, under US law it has long been the case that a US registered broker dealer must facilitate securities related transactions with US clients. Therefore, it will be manageable for most offshore banks and dealers to comply with the transaction level requirements in relation to their swaps and securities based swaps with US counterparties, given that there is existing infrastructure in place); and

(b) Whether a branch or separately identifiable department or division of a non-US bank may be treated as a separate entity for the purposes of the DFA and registration as a swap dealer. (There are several precedents in US securities and banking laws for treating branches of non-US banks as separate legal persons from the bank in certain circumstances. Foreign banks are advocating for the Commissions to permit them to register their US or non-US branches as swap dealers without subjecting the entire foreign bank and its offshore operations to US regulation as a swap dealer).

The current lack of clarity from US regulators has made planning difficult, if not impossible, for foreign banks operating in the US or dealing with US clients. A broad application of the US registration requirements will be overly burdensome on foreign banks. While global banks could limit the scope of the DFA by segregating their US swaps activities in a separate US subsidiary, in our view, this will not be a good outcome. Segregation will increase risk and decrease liquidity due to fewer opportunities for netting and margining on a portfolio basis. It will also result in severe capital and tax inefficiencies and will force customers to transact with less creditworthy entities. It will also potentially reduce the visibility that any single supervisor or regulator might have had into a bank's overall portfolio.

The financial industry has made numerous submissions to the Commissions on the extra-territorial aspects of the DFA but to date there has been no clarification from the Commissions on this issue. The optimal outcome for foreign banks is for the US regulators to oversee only those aspects of the foreign bank's swaps business that directly affect US counterparties and markets. In particular, US regulators should limit the application to non-US banks and swap dealers of US business conduct and other transaction specific requirements to their swap transactions with US counterparties. US regulators should defer to home country regulators of non-US banks and swaps dealers for capital, risk management and other entity-level requirements.

For US regulators to insist on a broad extra-territorial application of the DFA would be contrary to the reciprocal recognition approach contemplated in the European Commission's MiFID consultation and would significantly diminish the likelihood of US institutions obtaining EU passports in the context of MiFID reform. This is because it would give US institutions a competitive advantage by permitting them to access the European markets on better terms than European institutions could access the US market.

2. US banks operating in Australia

US banks have been lobbying to have their non-US branches excluded from most of the DFA regulations on the grounds that it could place them at a competitive disadvantage with non-US banks. Currently the new US regulatory regime will apply to foreign branches of US banks (presumably for the policy reason that the activities of foreign branches could have an impact on the overall financial position of the US bank). This approach will likely disadvantage US banks in foreign swaps business if non-US regulators do not adopt comparable regulation. For example, there is no exemption from the DFA margin requirements for swaps or securities based swaps entered into by an Australian branch of a US entity that are not centrally cleared by a US regulated clearing house. Given it is unlikely that many OTC derivatives which reference Australian underlyings will be centrally cleared by a US clearing house[2], Australian branches of US banks will be at a competitive disadvantage if they are subject to more onerous margin requirements and capital charges than their Australian bank competitors. At this stage, it appears unlikely that many overseas jurisdictions will adopt regulations as comprehensive and prescriptive as in the US, so this remains a major issue for foreign branches of US financial institutions. Of course, to the extent that Australian branches of European banks are subject to more onerous regulation by their home regulator than are their Australian bank competitors, European banks will also be at a relative competitive disadvantage.

3. Central clearing

The G20 push towards standardising derivatives contracts and central clearing will also likely impact Australian market participants. Foreign bank participants in the derivative markets in Australia will be required by their home regulators in the US or European Union to centrally clear at least some of their OTC derivatives.

For a combination of reasons, including operational and balance sheet efficiency, it is likely that a small number of offshore central clearing houses will clear most derivatives trades. From the perspective of a global investment bank, it is operationally more efficient to have a limited number of central clearing counterparties, as this will cut down on the number of operations staff, the number of payments to be made and the number of clearing house exposures for risk management staff to monitor. From the perspective of a client who is active in derivatives markets around the world, it is operationally more efficient to have only one or two margin or payment obligations each day rather than potentially having to make multiple payments to multiple clearing houses across multiple time zones. A concentration of positions at a small number of clearing houses is also likely to result in greater margin offsets and therefore, less capital utilisation.

From the perspective of an international bank, the move towards central clearing of derivatives such as rates, credit default swaps and certain foreign exchange contracts is not as dramatic as it might seem. This is because, for operational reasons and (in many cases) client preference, international banks currently book many of these derivatives trades to offshore branches (in Deutsche Bank's case,

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[2] This is because of, (i) the likely lack of demand in the US making it uneconomic for US clearing houses to clear OTC derivatives with Australian underlyings, (ii) the fact that the underlyings are Australian based and denominated in Australian dollars, and (iii) the time zone difficulties.

mostly London or Frankfurt) and therefore, the central clearing of these trades should, subject to the comments below, have minimal impact on local operations.

4. Council of Financial Regulators discussion paper on central clearing of OTC derivatives

On 17 June 2011, the Reserve Bank on behalf of the Council of Financial Regulators (comprising the the Reserve Bank itself, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Commonwealth Treasury) issued a discussion paper on central clearing of OTC derivatives in Australia as part of its response to the Pittsburgh Commitments. In summary, the Council agencies are considering the case for a requirement that activity in Australian dollar denominated interest rate derivatives be centrally cleared and whether this should take place domestically. The proposal is that the mandatory clearing requirement would apply to financial institutions acting in the domestic market, subject to exemptions for certain participants depending on their size or class.

Given that interest rate swaps comprise by far the bulk of the OTC derivatives market globally and in Australia (although FX derivatives are also a significant component of the OTC derivatives markets in Australia), it is commendable that the Council has focussed on those derivatives that pose the greatest risk.

As the Council notes in the paper, there is currently no central clearing of OTC derivatives in Australia. While offshore clearing exists and is gearing up for a greater role once central clearing is mandated in offshore jurisdictions, the Council has expressed a concern that, where offshore CCPs are clearing domestic markets that are of systemic importance, this may introduce risks to the Australian financial system that do not currently exist.

What central clearing does exist currently in Australia is fragmented. ASX Clear, the CCP for Australian equities, is not open to bank participants but only broker dealer subsidiaries. This means that the current participant criteria for ASX Clear are not conducive to ensuring that the best quality credits are underwriting clearing house risk. This factor has probably impeded the growth of a viable third party clearing market in Australian equities. ASX Clear (Futures) is the CCP for futures and options in interest rates, equity, energy and commodity products which are traded on ASX 24 (formerly the Sydney Futures Exchange). Given that ASX Clear (Futures) is open to bank participants, this may be the more logical local CCP for clearing of Australian dollar denominated interest rate derivatives. However, as the technology required to value and margin long-dated derivatives is different to that required for a generic exchange traded product, ASX Clear (Futures) would need to invest in new technology and infrastructure if it were to broaden its clearing mandate.

It is important that any regulatory initiatives by the Australian Government in relation to CCPs do not restrict competition in central clearing services or create a monopoly in central clearing services for Australian dollar denominated interest rate derivatives. Those outcomes would adversely affect efficiency for many offshore participants and also likely result in higher costs for participants (which will ultimately be passed on to Australian borrowers in the form of higher interest rates).

Given that foreign investors comprise a significant proportion of the Australian interest rate derivatives market (see chart below), it is questionable whether there will be much demand for a local clearing house.

Largest OTC Derivatives Dealers Active in Australia[a]

Dealer	**HQ**	**FX derivatives** (b)	**Interest rate derivatives** (c)	**Equity derivatives**	**Credit derivatives**
ANZ Banking Group	Australia	X	X		X
Bank of America ML	US			X	
Bank of Scotland plc	UK		X		
Bank of Tokyo-Mistubishi UFJ	Japan	X			
Barclays Capital	UK	X			
BNP Paribas	France	X	X		X
Citi	US	X	X	X	X
Commonwealth Bank	Australia	X	X		X
Deutsche Bank AG	Germany	X	X	X	X
Goldman Sachs	US			X	
HSBC Bank Australia	UK	X	X		
J.P. Morgan Chase	US	X	X	X	X
Macquarie Group	Australia	X	X	X	X
National Australia Bank	Australia	X	X	X	X
RBS Group (Australia)	UK		X		
Royal Bank of Canada	Canada	X			
State Street	US	X			
UBS AG	Switzerland	X	X		X
Westpac Banking Corp	Australia	X	X	X	X

(a) FX derivatives dealers are top 15 by turnover from RBA 2010 FX survey, equity derivatives dealers are 2009 AFMA market report survey respondents, dealers for other categories are 2010 AFMA market report survey respondents. Not all dealers are active in all products within a category.
(b) Includes FX swaps, forwards and options.
(c) Includes single and cross-currency rate swaps, forward rate agreements, overnight indexed swaps, and interest rate options.
Sources: AFMA; RBA

The merits of Australian based central clearing of OTC derivatives are complex. Some examples of the challenges:

(a) As noted previously, for operational and efficiency reasons, many foreign banks book their interest rate derivatives to a central offshore branch (in Deutsche Bank's case, it is the Frankfurt branch). To centrally clear these trades in Australia, it is likely that local infrastructure would be needed. This will increase costs for the foreign banks and reduce efficiencies to the detriment of the counterparties who deal with them.

(b) Our Sydney Rates desk is currently centrally clearing interest rate swaps with LCH Clearnet in London. Under the LCH Rules (Regulation 25), clearing participants may be compelled to bid on a basket of foreign currency denominated swaps if there is a default by a clearing member. Many local Australian banks may not want to be subject to this requirement because foreign currency denominated swaps may be outside their core competency or create operational risks given the time zone differential. Therefore, the services offered by LCH may not suit all Australian financial institutions.

(c) As I have also already said, unless the CFTC softens its approach on extra-territoriality, US banks dealing in Australian dollar denominated swaps will be required to clear those swaps with a US regulated clearing house or face higher capital charges and/or margin requirements.

Should the Australian Government choose to mandate local central clearing of Australian denominated interest rate swaps there is a real risk that this will fragment the interest rate swaps market in Australia into a domestic market and an offshore market to everyone's detriment, including the Australian economy and financial system.

5. Concluding comments

While the US is much more advanced than the other G20 members in meeting the Pittsburgh Commitments, there is still much uncertainty around the practical application of the Dodd Frank Act reforms – including the extra-territorial application and scope.

It seems highly questionable whether the other G20 members will be able to finalise and implement new derivatives regulations by the end of 2012 as planned when one considers that new market infrastructure will be required and new regulations must be drafted, finalised and then implemented with sufficient lead time for market participants to formulate policies, procedures and systems and to re-document their clients.

Regulatory arbitrage looks like being a major issue for the G20 OTC derivatives reforms given that it is unlikely that European regulations will be as prescriptive and all encompassing as the US regulations. Asia, with its growing importance in world financial markets, also appears to be taking a more moderate approach to OTC derivatives regulatory reform.

The DFA reforms, and similar European reforms, will likely result in higher costs and liquidity demands for end-users. Together with the impact of the Basel III capital requirements, the likely outcome of the reforms is an increase in pricing spreads in the global derivatives market. In effect, this is a large-scale regulation-driven re-pricing of risk. Whether this will ultimately be a good thing for the economies of the jurisdictions adopting these reforms, remains to be seen.

Certainly it is overly optimistic to expect that the current regulatory reforms will eliminate the risk of a future financial crisis. As Warren Buffett once said, “The managers at fault periodically report on the lesson they have learned from the latest disappointment. Then they usually seek out future lessons.”

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